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Research Update:

Ratings On The Republic of Bulgaria Raised To 'BBB-/A-3' On External Strength; Outlook Stable

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Ratings:
Foreign and Local Currency: BBB-/Stable/A-3

For further details see ratings list.

Overview

- Solid external performance has strengthened Bulgaria's credit metrics, with the economy now more export-driven and less leveraged than previously.
- Public financial management has been prudent, in deference to the currency board regime.
- We are therefore raising our sovereign credit ratings on Bulgaria to 'BBB-/A-3' from 'BB+/B'.
- The stable outlook on Bulgaria balances improving growth prospects and a track record of conservative fiscal policy against the potential re-emergence of political instability.

Rating Action

On Dec. 1, 2017, S&P Global Ratings raised its long- and short-term foreign and local currency sovereign credit ratings on Bulgaria to 'BBB-/A-3' from 'BB+/B'. At the same time, we raised our transfer and convertibility (T&C) assessment to 'A-'. The outlook is stable.

The upgrade reflects Bulgaria's improving external metrics, underpinned by a multiyear expansion of exports, amid a rise in domestic savings. In our view, the risk of material and abrupt shifts in external financing flows, particularly in foreign direct investment (FDI), has reduced significantly.

Outlook

The stable outlook reflects balanced risks to the ratings on Bulgaria.

We might take a positive rating action over the next 24 months if: (i) alongside strengthening economic recovery, we observed further reductions in the Bulgarian banking sector's nonperforming loans improving the country's monetary flexibility, and if the government's fiscal performance strengthened further beyond our expectations, resulting in a buildup of more substantial fiscal buffers; or (ii) if the Bulgarian lev were granted entrance to the Exchange Rate Mechanism (ERM) II, which we think would further bolster the credibility of Bulgaria's monetary framework, also by providing additional external buffers.

Conversely, we could take a negative rating action should, contrary to our expectations, balance of payments pressures re-emerge, growth falter, or fiscal performance deteriorate. An unexpected and material hike in contingent liabilities to public finances could also put pressure on the ratings.

Rationale

Bulgaria's sound government and external balance sheets support the rating. At the same time, the country's relatively low income levels, weak institutional settings, and adverse demographic profile constrain the ratings. Another credit weakness, in our view, is the Bulgarian government's and central bank's limited policy flexibility due to the country's fixed exchange rate regime. We recognize, however, that Bulgaria's currency board has been an important anchor of stability for the country.

Institutional and Economic Profile: Strong cyclical recovery to continue in 2018, but poor demography and weak institutions will constrain longer-term growth

- The outlook for economic growth has improved.
- Cyclical recovery and strong EU funds offer the government an opportunity to implement structural reforms and increase public savings.
- The new coalition government is likely to remain stable over the next 12 months.

Improving labor market conditions, recovering EU funds, and a favorable external environment should solidify Bulgaria's growth rates at just under 4% in 2017-2018. This is well in line with the growth reported in 2015-2016 and in contrast to sluggish economic performance in the years following the 2008-2009 global financial crisis. Domestic demand is likely to remain the major contributor to growth, leading to a gradual shift of the current account surplus toward small deficits.

Over the longer term, as the working age population ages and shrinks—not least due to net emigration of young and skilled Bulgarians—growth rates will likely moderate. If these constraints are not tackled by advances in institutional reforms—such as measures directed at increasing judicial independence, enhancing public administration and the governance of state-owned enterprises, and addressing the low quality of public services—potential GDP growth is unlikely to exceed 2.5%. Growth rates of that magnitude will constrain the pace of Bulgaria's income convergence with the EU. At $8,000, Bulgaria's GDP per capita is the lowest in the EU.

Following snap elections in March 2017, the center-right GERB party formed a coalition with the United Patriots. Given that key figures, including Prime Minister Boyko Borissov, have resumed their previous roles, we expect a high degree of policy continuity. Despite sticking points between coalition members, we do not foresee another early election in the next 12 months as Bulgaria assumes the rotating presidency of the EU next year. However, the need for a caretaker government between January 2017 and May 2017 illustrates the relative instability of Bulgarian governments in the past few years, as early elections have been a frequent occurrence. Political volatility and a weak institutional environment partly explain Bulgaria's subdued private investment activity in 2010-2016.

Flexibility and Performance Profile: Strong public finances and external balance sheet, but limited monetary flexibility

- Bulgaria’s export base is broadening and remains resilient to labor cost growth; external indebtedness has decreased as has the economy’s reliance on debt-type FDI.
- The government’s balance sheet remains strong.
- We see signs of improvement in the banking system given increased capital buffers, declining legacy nonperforming loans (NPLs), and steps toward enhancing banking supervision and resolution frameworks.

Bulgaria is likely to see another year of a strong current account surplus in 2017 at around 3% of GDP, crowning a period of steady growth in real exports in recent years. Although we expect the current account surplus to narrow gradually and shift into deficits in 2020 as higher domestic demand generates more imports, export growth will remain sound.

Bulgaria’s export base has widened and diversified in the past few years. Although the export of goods with high import content and moderate added value—such as refined petroleum—still plays some role, the country is being increasingly integrated into the EU manufacturing supply chains (demonstrated, for example, by the emergence of the automotive parts industry). This is amplified by the ongoing boom in tourism (partly helped by instability insecurity in competing destinations) and information and communications technology (ICT) services exports, and reflected in an increase of goods and exports by over $15 billion since 2010. Exports now account for an estimated 65% of GDP in 2017 versus 50% in 2010. Moreover, as demonstrated by 2016-2017, there is substantial upside potential for wage growth without affecting competitiveness.

Current account surpluses in 2017-2019 will support external deleveraging (although at a slower pace than in recent years) and keep the public and banking sectors in net external creditor positions. Even though the reduction in Bulgaria’s external indebtedness might be overestimated due to the still-material stock of debt-like inward FDI, we now see a lower risk that it could exert balance of payments pressures in case of accelerated repatriation of profits and equity. The debt-type portion of inward FDI has reduced to some 28% in 2017 from over 40% in 2012. In addition, FDI is increasingly entering export-oriented industries.

Unlike many of its Central and Eastern Europe peers, Bulgaria’s fiscal policy remains conservative. Last year, the government operated a balanced budget at the general government level. At the same time, we think that some spending pressures beyond the existing medium-term budgetary framework could arise from underfinanced public services or the need to step up investment in social infrastructure . We therefore anticipate that general government deficits will average 0.5% of GDP over 2018-2020, higher than the government’s own fiscal target of a slight surplus of the general government by 2020.

Fiscal contingent liabilities that could crystalize include those from the energy sector, although the government has recently reduced losses at Natsionalna Elektricheska Kompania (NEK). The government provided a zero-interest loan of 1.4% of GDP to NEK following the arbitration court decision to compensate Russia-based Atomstroyexport for equipment already produced for the cancelled Belene nuclear power plant. The government will have to decide what to do with the equipment: sell to another country or even complete the plant, as had been discussed previously. If neither of these scenarios is successful, this loan could transform into an outright budget expenditure.

That said, tax-rich consumption-driven growth as well the government's accumulated liquidity buffer (some 10% of GDP) will likely allow Bulgaria to easily accommodate such fiscal risks. We project that general government debt net of liquid assets will stay largely flat at a modest 15%-16% of GDP through 2020. We note that about 80% of total government debt is denominated in foreign currency, mainly euros. Bulgaria's low debt burden grants the country fiscal space to respond to external and domestic shocks, should they arise. This is all the more important given Bulgaria's currency board arrangement. Budget deficits and injections into the Bulgarian Deposit Insurance Fund (in 2014) were key reasons behind the doubling of gross general government debt from 15% of GDP in 2010 to just under 30% last year.

As a result of last year's asset quality review by the Bulgarian authorities, three domestic financial institutions replenished their additional capital buffers. Most prominently, First Investment Bank had to increase its additional capital buffers by Bulgarian lev 206 million (about €105 million) as an outcome of the stress test's adverse scenario, and the bank delivered on this recommendation via its 2016 profits. This has reduced the potential fiscal costs of supporting the banking system should it experience a loss of confidence. While the banking sector is generally adequately capitalized, NPLs in the sector remained at a relatively high 11.4% of total loans (according to Bulgarian National Bank [BNB] data) in October 2017, although we note a decreasing trend over recent years.

As per its charter—and according to the currency board regime under which it operates—the BNB's ability to act as a lender of last resort is limited. BNB can provide liquidity support to the banking system only to the extent that its reserves exceed its monetary liabilities. Even then, support can occur only under certain conditions and for short periods, against liquid collateral.

The Bulgarian lev is currently not part of ERM II, the precursor to eurozone entry. However, we think that the country could move toward ERM II over the next couple of years even though the political hurdle of receiving the invitation backed by all eurozone members is high. Until then, policymakers' commitment to the currency board remains strong. Bulgaria's foreign currency reserves comfortably cover the monetary base by over 1.7x as of October 2017.

The currency board was introduced in 1997 in the wake of a banking crisis amid hyperinflationary conditions, which were fueled by central bank financing of budget deficits. The board successfully lowered price inflation and prevented further episodes of hyperinflation. Headline inflation will be positive in 2017 following three years of deflation, although we note that core inflation has been picking up very modestly so far.

With Bulgaria's adoption of the EU Banking Resolution and Recovery Directive in 2015, the failure of a bank will necessitate a bail-in of shareholders, creditors, and then a resolution fund. Only after exhausting these options would a bank be able to resort to government support. Banking supervision and regulation is gradually strengthening following the lessons learned from the liquidity crisis and the collapse of KTB (Corporate Commercial Bank) in 2014. For example, we note that the BNB has consistently implemented measures to ensure the stability of banks (including subsidiaries) by strengthening their liquidity and capital buffers. Additionally, the BNB has taken steps to increase the liquidity of Greek banks' subsidiaries (which account for some 10% of the sector's assets), such as mandating higher deposits with the BNB, increasing the proportion of liquid assets held, and reducing exposure to parent banks.

At the same time, the implementation of this new set of regulation and crisis management tools remains to be tested. Although Bulgaria is not formally a member of the eurozone, a line of support from the European Central Bank is available to the BNB regarding any confidence-related losses arising at Greek bank subsidiaries. Details of this support, such as how it can be obtained or whether collateral would be needed, have not been released.

Key Statistics

Table 1

Republic of Bulgaria Selected Indicators

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. LC)	81	82	82	84	89	94	99	105	110	115
Nominal GDP (bil. $)	57	54	56	57	50	53	57	61	65	73
GDP per capita (000s $)	7.8	7.4	7.7	7.8	7.0	7.4	8.1	8.6	9.3	10.3
Real GDP growth	1.9	0.0	0.9	1.3	3.6	3.9	3.8	3.5	2.8	2.7
Real GDP per capita growth	2.6	0.6	1.5	1.9	4.2	4.6	4.3	4.0	3.3	3.2
Real investment growth	(4.4)	1.8	0.3	3.4	2.7	(6.6)	4.5	4.0	4.5	4.5
Investment/GDP	21.5	21.9	21.3	21.4	21.2	19.1	19.3	19.5	19.9	20.3
Savings/GDP	21.8	21.1	22.6	21.5	21.2	24.5	22.5	22.0	20.8	20.1
Exports/GDP	59.1	60.8	64.7	65.0	64.1	64.0	64.7	65.2	65.4	64.7
Real exports growth	12.6	2.0	9.6	3.1	5.7	8.1	4.4	4.4	3.3	2.3
Unemployment rate	11.3	12.3	13.0	11.4	9.2	7.6	6.5	6.4	6.3	6.0
EXTERNAL INDICATORS (%)										
Current account balance/GDP	0.3	(0.9)	1.3	0.1	(0.0)	5.3	3.2	2.5	0.9	(0.2)
Current account balance/CARs	0.5	(1.2)	1.7	0.1	(0.1)	7.5	4.5	3.4	1.2	(0.3)
CARs/GDP	66.0	68.9	73.9	72.5	71.3	70.9	71.6	71.9	71.7	70.6
Trade balance/GDP	(6.5)	(9.5)	(7.0)	(6.5)	(5.8)	(2.0)	(3.2)	(3.8)	(4.9)	(5.8)
Net FDI/GDP	2.9	2.5	3.0	2.1	5.1	0.7	1.9	1.9	1.9	1.9
Net portfolio equity inflow/GDP	0.1	(0.1)	(0.3)	(1.0)	(0.6)	(0.2)	(0.5)	(0.5)	(0.5)	(0.5)

Table 1

Republic of Bulgaria Selected Indicators (cont.)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Gross external financing needs/CARs plus usable reserves	124.1	122.8	117.4	121.6	118.9	104.3	99.6	101.1	97.9	100.0
Narrow net external debt/CARs	8.1	5.0	0.7	(3.2)	(17.3)	(25.3)	(30.9)	(35.8)	(35.9)	(36.5)
Net external liabilities/CARs	105.3	106.4	93.5	84.6	71.7	50.8	40.0	32.0	26.6	22.7
Short-term external debt by remaining maturity/CARs	48.4	43.8	41.6	41.1	44.2	29.6	26.8	24.8	22.0	21.2
Usable reserves/CAPs (months)	2.3	2.2	2.3	1.9	2.6	2.2	2.9	2.5	2.8	2.6
Usable reserves (mil. $)	6,750	7,914	6,544	7,640	6,430	9,322	8,775	10,947	10,990	11,298
FISCAL INDICATORS (%, General government)										
Balance/GDP	(2.0)	(0.3)	(0.4)	(5.5)	(1.6)	(0.0)	0.0	(0.6)	(0.6)	(0.7)
Change in debt/GDP	1.0	1.7	0.3	10.3	0.5	4.6	(1.9)	0.6	0.6	0.8
Primary balance/GDP	(1.2)	0.5	0.4	(4.6)	(0.7)	0.9	0.9	0.2	0.2	0.1
Revenue/GDP	31.9	34.1	37.2	36.6	39.1	34.9	34.9	35.0	35.5	35.6
Expenditures/GDP	33.8	34.5	37.6	42.1	40.7	35.0	34.9	35.6	36.1	36.4
Interest /revenues	2.3	2.3	2.0	2.4	2.4	2.6	2.4	2.3	2.3	2.3
Debt/GDP	15.2	16.7	17.0	27.0	26.0	29.0	25.6	24.9	24.3	23.9
Debt/Revenue	47.8	48.9	45.7	73.7	66.5	83.1	73.2	71.0	68.5	67.1
Net debt/GDP	8.9	9.0	11.0	17.3	18.0	16.5	15.6	15.4	15.3	15.3
Liquid assets/GDP	6.4	7.7	6.0	9.7	8.0	12.5	9.9	9.4	9.0	8.6
MONETARY INDICATORS (%)										
CPI growth	3.4	2.4	0.4	(1.6)	(1.1)	(1.3)	1.1	1.6	2.0	2.1
GDP deflator growth	6.0	1.6	(0.7)	0.5	2.2	2.2	1.8	1.8	2.0	2.3
Exchange rate, year-end (LC/$)	1.51	1.48	1.42	1.61	1.79	1.86	1.66	1.73	1.63	1.57
Banks' claims on resident non-gov't sector growth	3.9	2.8	0.2	(7.6)	(1.6)	1.8	4.3	4.5	4.5	4.7
Banks' claims on resident non-gov't sector/GDP	67.3	68.1	68.1	61.8	57.5	55.0	54.3	53.9	53.7	53.5
Foreign currency share of claims by banks on residents	51.3	49.5	47.6	42.1	33.1	29.1	N/A	N/A	N/A	N/A
Foreign currency share of residents' bank deposits	45.3	41.2	41.2	40.9	40.3	38.7	N/A	N/A	N/A	N/A
Real effective exchange rate growth	2.7	(1.9)	1.3	(0.5)	(3.2)	0.2	N/A	N/A	N/A	N/A

Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. LC—Local currency. CARs—Current account receipts. FDI—Foreign direct investment. CAPs—Current account payments. The data and ratios above result from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

Republic of Bulgaria Ratings Score Snapshot	
Key rating factors	
Institutional assessment	Neutral
Economic assessment	Neutral
External assessment	Strength
Fiscal assessment: flexibility and performance	Strength
Fiscal assessment: debt burden	Strength
Monetary assessment	Weakness

S&P Global Ratings' analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of S&P Global Ratings' "Sovereign Rating Methodology," published on Dec. 23, 2014, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with S&P Global Ratings' sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology - December 23,2014
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18,2009
- General Criteria: Use Of CreditWatch And Outlooks - September 14,2009
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings - April 07,2017

Related Research

- Sovereign Risk Indicators - October 13, 2017. An interactive version is also available at http://www.spratings.com/sri.
- Sovereign Ratings History - November 6, 2017
- Global Sovereign Rating Trends Third-Quarter 2017 - October 6, 2017
- Credit Trends: 2016 Sovereign Ratings Update: Outlook And CreditWatch Resolutions – April 18, 2017
- Global Sovereign Rating Trends Midyear 2017 – July 12, 2017
- Default, Transition, and Recovery: 2016 Annual Sovereign Default Study And Rating Transitions - April 3, 2017
- Sovereign Debt 2017: Global Borrowing To Drop By 4% To US$6.8 Trillion – February 23, 2017
- Banking Industry Country Risk Assessment: Bulgaria - December 30, 2016

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that external risk had improved. All other key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

	Rating	
	To	From
Bulgaria (Republic of)		
Sovereign Credit Rating		
Foreign and Local Currency	BBB-/Stable/A-3	BB+/Positive/B
Transfer & Convertibility Assessment	A-	BBB+
Senior Unsecured		
Foreign and Local Currency	BBB-	BB+
Short-Term Debt		
Foreign and Local Currency	A-3	B

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P

Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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